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RMB BASICALLY STABLE

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11. (SBU) Summary: In meetings with visiting Fed Governor Warsh, Chinese researchers and bankers expressed concern that the U.S. economic downturn would become a protracted recession. They worried about the impact on China's economy, and expected problems such as rent-seeking and corruption to spring from China's plans to stimulate growth through fiscal and monetary measures. Central bank officials continue to affirm that Chinese financial institutions are not experiencing liquidity problems, and stressed that despite the recent depreciation of the RMB there had been no fundamental change in exchange rate policy. ICBC notified of its desire to buy a controlling stake in a California-based bank. End Summary.

12. (SBU) On December 3, 2008, Federal Reserve Bank Governor Kevin Warsh met with Development Research Center (DRC) Director Xia Bin, China Securities Regulatory Commission (CSRC) Vice Chairman Yao Gang, People's Bank of China (PBOC) Vice Governor Yi Gang, Industrial and Commercial Bank of China (ICBC) Chairman Jiang Jianqing, China Banking Regulatory Commission (CBRC) Chairman Liu Mingkang, and Bank of Beijing Executive Directors Bruno Houdmont and Bashar Samra (representatives of ING detailed to BoB). Discussions focused mainly on the causes, impact, and policy responses to the current global financial crisis, and related concerns including bank liquidity, economic reform, and exchange rate policies.

Rising Concern about the Global Economy . . .

13. (SBU) Chinese banking and government officials expressed concerns that the U.S. financial crisis would lead to a protracted and severe U.S. recession. Most interlocutors viewed the Chinese economy's prospects as closely tied to the U.S. economy's and thus pressed Warsh for his views on when the U.S. economy would recover. CSRC Vice Chairman Yao expressed concern about the impact of deteriorating U.S. consumer credit on financial stability and household consumption. Yao was also interested in the current debate on and prospects for reform of the U.S. financial regulatory structure, particularly in light of the Federal Reserve's provision of liquidity to non-bank financial institutions. DRC's Xia explained that while a housing bubble, compensation systems and high leverage had all contributed to the U.S.

financial crisis, an important cause was global macroeconomic imbalances. ICBC Chairman Jiang worried about the loss of confidence in China and the global economy. Even sound firms are afraid to invest due to the uncertain outlook. Individuals are cutting back their consumption - not because of insufficient income but because of their deteriorating outlook. He stressed it is therefore important for the Chinese government to sustain confidence.

. . . and Rapidly Deteriorating Chinese Economy

¶4. (SBU) Chinese officials generally agreed that economic data in October had dropped more quickly than they expected with power generation declining, something unprecedented in many years. Most expect real GDP growth for 2008 Q4 and early 2009 to be lower than the 9% real growth (y/y) for the third quarter. The Chinese stimulus package will help offset the decline in external demand with domestic growth; for 2009, China could still achieve 9% GDP growth if the situation in the U.S. doesn't worsen. DRCQs Xia Bin was confident that China can maintain at least 8 percent real GDP growth in 2009. The rise of government revenues as a percent of GDP, a roughly balanced budget, and continued urbanization give China ample room for fiscal stimulus. While Xia believes China needs to pursue more consumption-led growth, he stressed this will remain difficult in the short-term.

¶5. (SBU) PBOCQs Yi noted that the main channel for contagion of the U.S. and European financial crises has

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been through trade, although ChinaQs diversification of export markets away from the U.S. and Europe over the past few years has helped cushion the impact. Yi also believes that ChinaQs high household savings and banks capital adequacy ratios give both households and financial institutions a cushion to help absorb the decline in external demand.

Supporting Growth Presents Challenges

¶6. (SBU) DRCQs Xia is concerned that the four trillion RMB stimulus package could encourage corruption and rent-seeking and would present an opening for supporters of greater state-directed economic planning. With Premier Wen Jiabao aware of these risks, the government is trying to find appropriate ways to strengthen oversight of additional spending. Xia predicted that the December 8-9 government economic work conference would focus on measures to increase domestic demand and consumption, including: raising the threshold for the personal income tax; stimulating the housing market by cutting interest rates further, and/or lowering the minimum down payment for purchases of second homes; and increasing pensions for retirees.

¶7. (SBU) Bank of Beijing executives said that while regulators are encouraging banks to maintain lending growth, they are not yet forcing banks to make loans that the banks do not deem commercially viable. However if the economic downturn worsens, they expect banks will face more pressures to lend. Mr. Samra believed that real estate is the major risk for banks, though BoBQs exposure to real estate is relatively small at only 14% of assets. While BoBQs borrowers had been sensitive to interest rate hikes, they were less certain whether interest rate cuts would spur increased borrowing given the deteriorating outlook.

Exchange Rate to Remain Basically Stable

¶8. (SBU) PBOCQs Yi said the U.S. government Qshould not worryQ as there has been no change in exchange rate policy. He noted that in the second half of 2008, the RMB-USD rate has been Qbasically stable,Q but in the context of a strong USD that had caused the RMB to appreciate significantly on a nominal and real-trade weighted basis. Yi added that in the near term the RMB was likely to remain Qbasically stableQ against the US dollar, and in this context fluctuations in either direction were Qperfectly normal.Q Over the long-term China is still committed to the goal of a convertible currency.

PBOC Taking Steps to Maintain Bank Liquidity

¶9. (SBU) PBOCQs Yi said liquidity remains ample in China; in fact just three months ago there were concerns about excessive liquidity. November data will show very large increases in bank lending. According to Jiang, the solid growth in the real economy allowed Chinese banks to grow rapidly while paying less attention to QfakeQ financial derivatives than their western counterparts. Only foreign banks, which are a tiny portion of ChinaQs banking sector, have experienced liquidity problems. Through moral suasion, PBOC and CBRC encouraged Chinese commercial banks to resume normal lending to the foreign banks. Also, the PBOC has established a facility to provide liquidity similar to the Federal ReserveQs TAF (term auction facility). Foreign banks can use Qwhatever they haveQ as collateral for this facility, including foreign assets. This will allow foreign banks who need RMB liquidity to borrow foreign currency from their parent banks, and use the borrowed funds as collateral for an RMB loan from the PBOC, without requiring approval from the State Administration of Foreign Exchange to bring the foreign currency into China.

Macro Stimulus Consistent with Structural Reform?

¶10. (SBU) PBOCQs Yi said the economic downturn is an
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opportunity for further structural adjustment of the economy. China can speed the transfer of resources out of some sectors and enterprises, although certain ministries, SOEs, and local governments will resist this. To promote this, China needs to accelerate its efforts to strengthen its social safety net, as it is much more efficient to support directly household incomes than prop up inefficient enterprises.

¶11. (SBU) Yi also stressed the importance of maintaining progress on reforming Chinese banks into more commercially-oriented entities, particularly by emphasizing good corporate governance and risk management; the former was gradually improving, the latter was much better. The Qgood newsQ is that ChinaQs banks are closer to international standards; the Qbad newsQ is that this is making them more pro-cyclical. However, despite the priority on sustaining growth it will not be possible for the Chinese government to press banks to lend to particular borrowers.

Committed to Reform, but Pace Will Slow

¶12. (SBU) CSRCQs Yao stressed that, while the U.S. financial crisis has raised doubts among some people about whether to continue financial opening and reform, Chinese leadership are committed to continuing but first need to analyze the reasons for and implications of the U.S. financial crisis.
DRCQs Xia said current problems might lead to Qfine-tuningQ of the pace of financial reform and opening, but

the policy and overall trend would not change. As ICBC Chairman Jiang noted, Qit is lucky that Chinese banking reform over the past few years occurred in such a good environment.

ICBC Seeks Controlling Stake in California Bank

¶13. (SBU) ICBC, the largest bank in China, believes that now is a good time to pursue foreign investment through mergers and acquisitions (M&A). ICBC is interested in acquiring small U.S. banks to expand its network and learn more about the US market. Mr. Jiang mentioned interest in a controlling share of East-West Bank in California, and asked Governor Warsh whether the Federal Reserve would have regulatory concerns. Warsh responded that while foreign investors would have to comply with U.S. banking regulations, the Federal Reserve has an Open mindQ towards foreign investment, and recommended that ICBC discuss any specific proposal with the appropriate Federal Reserve staff.

COMMENT: Balancing Rebalancing

¶14. (SBU) Chinese economic policy makers continue to grapple with how to cushion the macroeconomic downturn in an efficient manner without undermining progress made in modernizing the financial sector and rebalancing the economy. They appear well aware that more market-oriented banking and banking supervision practices tend to be more pro-cyclical and appear intent not to repeat the heavy handed moral suasion on banks to prop up state enterprises which occurred in prior cyclical downturns. They also appear committed to continue to resist pressure rising from vested interests to use the U.S. financial crisis as a pretext for backsliding on financial and exchange rate reforms, though the pace of financial liberalization and RMB appreciation will certainly slow. ICBCQs proposed investment in East-West Bank could be the second test, after China MinshengQs request to increase its stake in San Francisco-based bank UCBH Holdings, of whether the Federal Reserve will allow Chinese banks to take more than a 5-10 percent equity stake in U.S. banks.

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